

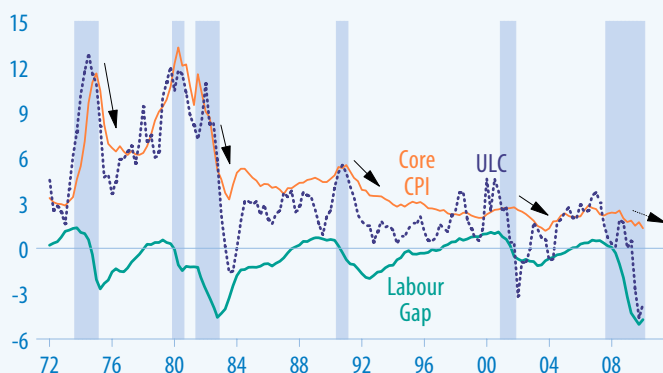
**TABLE 1
DECOMPOSING DISINFLATION**

United States (nsa : y/y % chng)

CPI	April 2010	April 2009
Furniture / Household Operations	-2.8	1.8
Clothing	-0.9	0.9
Recreation	-0.4	1.2
Owners' Equivalent Rent	-0.2	2.1
Food	0.5	3.3
Personal Care	0.8	1.9
Medical Care	3.6	3.0
Autos	4.8	-1.7
Education	5.0	5.4
Gasoline	38.3	-39.5

**CHART 1
SLACK KEEPS INFLATION IN THE SACK**

United States

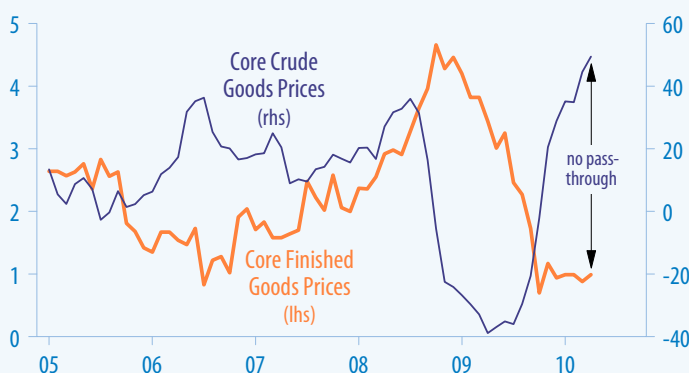


Core CPI, ULC = (y/y % chng) Labour Gap = (natural less actual unemployment rate : ppts)

**CHART 2
FACTORIES EATING HIGHER MATERIAL PRICES**

United States (y/y % chng)

Producer Prices



Deflation Déjà Vu

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Despite a surprisingly solid U.S. recovery, underlying inflation continues to ebb, a legacy of the massive amount of slack built up in the Great Recession. **As shown in Table 1, the prices of many goods and services are either falling or rising more slowly than a year ago.** If not for a 38% spike in gasoline prices, overall consumer prices would have risen just 0.5% in the past year instead of 2.2%. Core consumer prices rose a mere 0.9% in the past year to April, the slowest annual increase in four decades, and have changed little in the past four months. True, softer rents explain a good portion of the one-percentage-point drop in core inflation since April 2009. Still, the weakness in prices across a wide range of goods and services has been more than sufficient to offset sharp gains on a few items like health care, education and autos.

Inflation should decline further because:

- The unemployment rate is about four-to-five percentage points above its steady-inflation level. The current high rate discourages workers from demanding wage increases, while draining pricing power from retailers. Hourly wages are up just 1.6% y/y, while unit labour costs—the overwhelming driver of inflation—are falling (Chart 1). Lower labour costs have allowed manufacturers to absorb higher resource prices. Despite a 49% surge in core raw material prices in the past year, core finished goods prices rose just 1.0% (Chart 2).
- Rents should continue to soften in the wake of a near record-high 10.6% rental vacancy rate and record-high mortgage delinquencies and foreclosure inventories (keeping the number of unsold vacant homes elevated).
- Sturdy motor vehicle prices in the past year (owing to low inventories) have started to roll over, as vehicle demand has barely kept up with replacement rates.
- The trade-weighted dollar's 5% appreciation in the past six months, together with deflation in Japan and disinflation in Europe, should help dampen import costs. Euro area core inflation has halved to 0.7% in the past year, with prices falling outright in Ireland and Portugal.

CHART 3
NOT EXPECTING DEFLATION

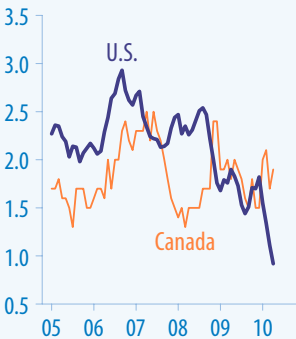
United States (percent)

TIPS Implied 5-Year Forward Inflation Rate



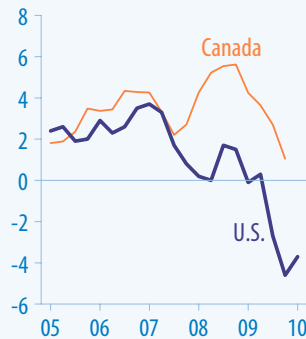
CHART 4
COST ADVANTAGE U.S.

Core CPI
(y/y % chng)



Unit Labour Costs

(s.a. : y/y % chng business sector)



- Commodity futures prices are down 10% in the past half year, while the slide in spot oil prices is starting to corral galloping gasoline prices.
- Deleveraging on the part of households, state governments and eventually Uncle Sam will dampen growth. Only in the unlikely event that the U.S. government loses its resolve to restrain deficits and turns to the printing press will public debts lead to rising inflation.

Despite this downward pressure, several factors weigh against deflation. First, not all services are in excess supply. Rising costs of medical care and education, which comprise one-tenth of the CPI basket, have added 0.4 percentage points to annual inflation. **Second**, though easing, inflation expectations remain near 2%, and a prolonged decline would likely be required before deflation takes root (*Chart 3*). **Third**, rising global demand should help commodity prices reverse recent declines, assuming concerns about Europe’s debt problems subside. **Fourth**, expected 3% GDP growth in the coming year should alleviate the intense downward pressure on wages stemming from high unemployment. All in, **these factors will likely prevent CPI inflation from slipping below 1% and core inflation from breaching 0.5% this year, and could lift inflation slightly in 2011.**

Still, further disinflation will shape the outlook for the economy, the Fed and financial markets this year. Slower rising prices will improve household purchasing power and U.S. trade competitiveness, notably vis-à-vis Canada where prices and labour costs are climbing faster (*Chart 4*). Disinflation will also restrain interest rates and

debt-service costs. Residential mortgage rates are again testing record lows, which should prop up home sales in the wake of the now-defunct tax credit.

Inflation has fallen faster than the Fed expected at the start of the year. Importantly, the April policy meeting minutes reveal that policymakers expect core inflation through 2012 to remain somewhat below the longer-run central tendency range of 1.7% to 2.0%, which is generally deemed the Fed’s inflation target. **Expected below-target inflation implies a strong aversion towards raising rates.** Should the recovery falter, thereby increasing the risk of deflation, the Fed would need to resume printing money and purchasing assets. Chairman Bernanke held the deflationary forces at bay through the Great Recession, but the war isn’t over.

The Bottom Line: Disinflation will likely continue this year, though the risk of deflation remains low barring a derailment of the U.S. recovery. Low inflation will likely keep the Fed on hold this year, supporting bonds, though long Treasuries could still weaken as the recovery takes firmer root. Stocks will find some support from the low-rate/steady-growth environment.

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